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No. 01-1209

In The

Supreme Court of the United States

THE BOEING COMPANY AND CONSOLIDATED SUBSIDIARIES,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

On Writ of Certiorari To
The United States Court of Appeals For The Ninth Circuit

BRIEF *AMICI CURIAE* OF CATERPILLAR INC., HEWLETT-PACKARD COMPANY, INTEL CORPORATION, KLA-TENCOR CORPORATION, LEXMARK INTERNATIONAL, INC., REEBOK INTERNATIONAL LTD., AND UNITED TECHNOLOGIES CORP. IN SUPPORT OF PETITIONERS AND REVERSAL OF THE DECISION BELOW

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INTEREST OF THE *AMICI CURIAE*

Amici Curiae are seven publicly held United States corporations representing a broad spectrum of industries,[1] including construction, mining, agricultural, and forestry machinery and engines, imaging and printing products and

[1] All parties to this proceeding have consented to the submission of this brief in letters of consent filed with the Clerk of the Court. This brief was not authored in whole or in part by counsel for a party to this proceeding, and no person or entity, other than the *amici curiae,* made a monetary contribution to the preparation or submission of this brief.

systems, computing systems, microprocessors, chipsets, semiconductor and microelectronics testing equipment, data storage devices, sports and fitness products, and elevators, escalators, heating, ventilating, air conditioning and refrigeration equipment, aircraft engines, and flight systems products. Each company engages in significant research and development ("R&D") activities and is profoundly interested in the export laws of the United States and the tax incentives enacted by Congress.

Amici curiae are adversely affected by the United States Court of Appeals for the Ninth Circuit decision in this proceeding which is wrong as a matter of law, conflicts with important national interests, and presents an irreconcilable conflict with a 1994 decision in the Eighth Circuit. For companies engaged in R&D efforts and producing products for export, and for companies considering the advantages of commencing or expanding export activities, the decision below is a serious obstacle and is detrimental to such activities. The Ninth Circuit decision imposes financial disincentives on companies conducting vital R&D activities and dilutes the value of important provisions enacted by Congress to stimulate export activities.

Caterpillar Inc. ("CAT") is incorporated in the State of Delaware, with its principal executive offices located in Peoria, Illinois. CAT is a leading producer of construction, mining, agricultural, and forestry machinery. CAT is also engaged in the design and manufacturing of engines for such machinery, electric power generation systems, vehicles and locomotives, and petroleum, construction, and industrial applications. In 2001, CAT's worldwide consolidated sales exceeded $20 billion, and approximately 51 percent of such sales were outside the United States. CAT spent $898 million on research and engineering programs in 2001, of which $696 million related to new prime products, major

component development, and major improvements of existing products.

Hewlett-Packard Company ("HP") is incorporated in the State of Delaware, with its principal executive offices located in Palo Alto, California. HP recently merged with Compaq Computer Corporation ("Compaq") to create the world's second largest information technology company. HP is a leading global provider of business and home products in its four major business segments: Imaging and Printing Systems, Personal Systems, Enterprise Systems, and Information Technology Services. HP is the world's largest provider of imaging and printing systems, supplying products that include printers, printing supplies, printing presses, scanners, and digital cameras. HP Personal Systems products include commercial and home personal computers ("PCs") and personal digital assistants ("PDAs"). HP Enterprise Systems products include UNIX servers, PC servers, business critical computing systems, network storage devices, and related software solutions. The Information Technology Services business segment provides leading customer support, consulting, outsourcing and other services that allow customers to take advantage of emerging technologies and business models. The markets for each of HP's four principal business segments are characterized by short product life cycles and require the vigorous development of new and enhanced products and services. Hewlett-Packard Laboratories ("HP Labs"), together with the R&D efforts within the four principal business segments, conduct R&D to provide a continuing flow of innovative, high-quality products and services and to enhance current product offerings. HP's (including Compaq) expenditures for R&D in fiscal 2001 totaled $4 billion. HP's research, product development, and manufacturing are conducted in the United States and in numerous locations throughout the

world. HP maintains operations in more than 120 countries worldwide and sells products and services into additional locations through various representatives and distributors.

Intel Corporation ("Intel") is incorporated in the State of Delaware, with its principal executive offices located in Santa Clara, California. Intel supplies the basic building blocks and ingredients of computer architecture and the internet economy. Intel is the world's largest semiconductor chip maker, and its products include microprocessors, which control the central processing of data in personal computers, servers, workstations, and other devices; chipsets, which perform essential logic functions surrounding the central processing units in computers based on Intel architecture processors; and embedded control chips for automobile engines and braking systems, hard disk drives, cellular phones, and laser printers. Intel's competitive position has developed in large measure because of its emphasis on R&D activities. In 2001, Intel's R&D expenditures totaled $3.796 billion, and were devoted to the development of new products, as well as the enhancement of existing products. Intel's products are produced in the United States and in numerous locations abroad, and are sold for use in countries throughout the world.

KLA-Tencor Corporation ("KLA-Tencor") is incorporated in the State of Delaware, with its principal executive offices located in San Jose, California. KLA-Tencor was formed in April 1997 through the merger of KLA Instruments Corporation and Tencor Instruments, two long-time participants in the semiconductor equipment industry. KLA-Tencor is the world's leading supplier of process control and yield management solutions for the semiconductor and related microelectronics industries. KLA-Tencor sells a broad spectrum of semiconductor equipment products designed to assist integrated circuit

manufacturers manage yield throughout the wafer fabrication process from the research and development phase to final mass production yield analysis. The markets served by KLA-Tencor are characterized by rapid technological development and product innovation. Accordingly, KLA-Tencor devotes a significant portion of its human and financial resources to R&D programs, and is committed to significant engineering efforts toward product improvement and new product development. The company's global customer base includes virtually every major semiconductor manufacturer in the world, and its products are sold throughout the United States, Europe, Asia-Pacific, and Japan.

Lexmark International, Inc. ("Lexmark") is incorporated in the State of Delaware, with its principal executive offices located in Lexington, Kentucky. Lexmark is a leading developer and manufacturer of printing solutions, including laser and inkjet printers for offices and homes, and a broad line of other office imaging products. Lexmark's products are sold in more than 150 countries in North and South America, Europe, Asia, and other locations throughout the world. In 2001, Lexmark's consolidated revenue totaled approximately $4.1 billion, and revenue derived from international sales comprised more than half of the total. Lexmark is a technology leader in its targeted areas and is actively engaged in the design and development of new products and enhancements of its existing products. Lexmark's process of developing new technology products is complex and requires innovative designs. In 2001, Lexmark's R&D expenditures were approximately $246 million.

Reebok International Ltd. ("Reebok") is incorporated in the Commonwealth of Massachusetts, and its principal executive offices are located in Canton, Massachusetts. Reebok is a global company, engaged primarily in the design

and marketing of sports and fitness products. Reebok is one of the world's leading companies engaged in the design, marketing, and distribution of sports, fitness, and casual footwear, apparel and equipment under the Reebok, Rockport, and Greg Norman brands, and footwear under the Polo Ralph Lauren brand. Reebok engages in product R&D and design activities at its product development facilities. R&D activities are integral to the company's success. Reebok places strong emphasis on technology and incorporates various proprietary performance technologies in its products. Reebok sells its products throughout the United States and in approximately 170 countries and territories worldwide. Reebok footwear and apparel products are distributed in the United States primarily through athletic retailers, sporting goods stores, and department stores. Reebok's sales outside the United States are conducted through its international distribution network, consisting of related entities and independent distributors around world.

United Technologies Corp. ("UTC") is incorporated in the State of Delaware, with its principal executive offices located in Hartford, Connecticut. UTC's operations are classified into four principal segments: Otis, Carrier, Pratt & Whitney, and Flight Systems. Otis is the world's largest elevator and escalator manufacturing and installation company. Carrier is the world's largest manufacturer of commercial and residential heating, ventilation, and air conditioning systems and equipment. Pratt & Whitney is among the world's leading suppliers of commercial, general aviation, and military aircraft engines. UTC's Flight Systems business includes Sikorsky Aircraft and Hamilton Sundstrand. Sikorsky Aircraft is one of the world's largest manufacturers of military and commercial helicopters.

Hamilton Sundstrand provides aerospace and industrial products and aftermarket services for a diverse group of industries worldwide. UTC's consolidated revenues in 2001 were approximately $28 billion, generated from sales in the United States and throughout the world. Technology can have a significant impact on UTC's operations and competitive position, and the company spends substantial amounts of its own funds on R&D. In 2001, those R&D expenditures were approximately 4.6 percent of total sales and totaled $1.254 billion.

On a cumulative basis, the *amici curiae* produce thousands of products in a wide variety of industries. Those products are sold in the United States and in markets throughout the world. Individually, each company conducts substantial R&D activities and is vitally interested in the tax incentives granted by Congress. The Ninth Circuit decision below seriously jeopardizes those incentives, and the *amici curiae* respectfully submit that it is essential for this Court to reverse that decision.

The *amici curiae* appear in this proceeding to enhance the Court's understanding of issues of vital interest to taxpayers across our country. Specifically, the Ninth Circuit decision frustrates and undermines policies of profound national interest: Encouragement of innovative R&D activities, and stimulation of exports from the United States.

STATEMENT

This proceeding involves an issue of fundamental importance involving R&D activities and the export tax incentives of the United States. Commencing in 1954, Congress provided tax incentives to encourage R&D efforts by United States businesses. *See, e.g.*, Internal Revenue

Code §§ 41, 174(a).[2] During the last sixty years, Congress has also enacted four separate tax regimes designed to stimulate and increase exports from the United States.[3] The taxable years at issue in the matter before the Court involve two of those export regimes, namely the Domestic International Sales Corporation ("DISC") provisions, and the Foreign Sales Corporation ("FSC") provisions.

The specific question presented in this proceeding concerns the application of a Treasury regulation[4] to the computation of export sales income under the DISC and FSC provisions of the Internal Revenue Code (26 U.S.C.).[5] In

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[2] References to sections of the Internal Revenue Code (26 U.S.C.) are to the Internal Revenue Codes of 1954 and 1986, as amended and in effect for the years at issue, unless otherwise stated.

[3] In 1942, Congress provided export tax incentives to "Western Hemisphere Trade Corporations." *See* Internal Revenue Code of 1939 § 109; Internal Revenue Code of 1954 §§ 921-922 (prior to repeal); S. Rep. No. 1631, 77th Cong., 2d Sess. 32, 111 (1942); H.R. Rep. No. 1337, 83d Cong., 2d Sess. 77 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 106 (1954). In 1971, Congress granted export tax incentives for "Domestic International Sales Corporations." *See* Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 497. The "Foreign Sales Corporation" regime was enacted in 1984. *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, §§ 801-805, 98 Stat. 494. Most recently, export incentives were enacted in the Extraterritorial Income Exclusion Act of 2000. *See* Pub. L. No. 106-519, 106th Cong., 2d Sess. (2000).

[4] References to sections of the regulations are to the Department of Treasury regulations, as published in 26 Code of Federal Regulations, and as in effect during the years at issue, unless otherwise stated.

[5] In the proceeding below, the parties agreed that for purposes of the issue in the present case there are no significant differences between the DISC and FSC regimes. *See* Pet. at 3, n.2; Pet. App. B. at 20a, n.2. References to "Pet." or "Pet. App." are to Petitioners' Petition For a Writ of Certiorari (and the Appendices thereto) in this proceeding (No. 01-1209). For convenience, the discussion herein is based solely on the DISC provisions, unless the context requires otherwise.

1994, the Eighth Circuit held that Treas. Reg. § 1.861-8(e)(3) (relating to the allocation of R&D expenses) was unreasonable and invalid when applied to the calculation of income under the DISC regime. *St. Jude Medical, Inc. v. Commissioner*, 34 F.3d 1394, 1396, 1402 (8th Cir. 1994). Seven years later, the court of appeals below reached the opposite conclusion on virtually identical facts.

Simply stated, the issue in this proceeding is whether, for purposes of calculating export benefits under the DISC regime, taxpayers must allocate R&D expenses to extremely broad product categories (such as "transportation equipment"), or whether taxpayers have an undeniable right to allocate R&D expenses to the more narrow product groups to which the expenses "directly relate." The Ninth Circuit below held that R&D expenses which were specific to particular products must be allocated to products sold for export, *even though those R&D expenses did not directly relate to the export products.* Conversely, the Eighth Circuit held the Treasury regulations provide taxpayers a right to choose recognized product or product line groups and to allocate R&D expenses to those specific product groups. *See St. Jude Medical,* 34 F.3d at 1396.

Under the DISC tax incentive regime, Congress allowed taxpayers to select one of three pricing methods to compute the maximum tax benefit from export activities. *See* I.R.C. § 994(a). The particular pricing approach at issue in this proceeding is the "combined taxable income" method ("CTI"), which is a net income concept calculated by determining gross export sales receipts and subtracting costs (including R&D costs) from those receipts. *See* I.R.C. § 994(b)(2).

The DISC legislative history provides that CTI is determined by deducting expenses "directly related" to the

production or sale of export property, and a portion of the expenses not allocable to "any specific item of income." H.R. Rep. No. 533, 92d Cong., 1st Sess. 74 (1971). The Treasury regulations follow this legislative intent and provide that costs treated as relating to export gross receipts are those "definitely related" to the export sales, and a ratable part of other expenses not definitely related to a class of gross income, "determined in a manner consistent with the rules set forth in [Treas. Reg.] § 1.861-8." Treas. Reg. § 1.994-1(c)(6)(iii).

For purposes of computing export income qualifying for the DISC incentive, the computations generally are made on a "transaction-by-transaction basis." Treas. Reg. § 1.994-1(c)(7)(i). As an alternative to transaction-by-transaction determinations, Congress intended to provide (and the regulations specifically grant) taxpayers the right to "group" transactions on the "basis of groups consisting of products or product lines." *See* H.R. Rep. No. 533, *supra*, at 74; Treas. Reg. § 1.994-1(c)(7)(i). The regulations further provide that the taxpayer's grouping choice "will be accepted" if it conforms with either (i) "recognized industry or trade usage," or (ii) "the two-digit major groups" of the Standard Industrial Classification ("SIC") manual, issued by the Office of Management and Budget. Treas. Reg § 1.994-1(c)(7)(ii). The Treasury regulations also provide that the taxpayer's grouping choice "shall be controlling," and costs "shall be allocated and apportioned to the items or classes of gross income * * * resulting from such grouping." Treas. Reg. § 1.994-1(c)(6)(iv).

These regulatory provisions establish basic principles in computing income subject to the DISC export incentives. First, a taxpayer is granted the right to "group transactions"

on the basis of specific "products or product lines." Treas. Reg. § 1.994-1(c)(7)(i). Second, the taxpayer's grouping choice "will be accepted" if it conforms to a recognized industry or trade usage standard. Treas. Reg. § 1.994-1(c)(7)(ii). Assuming the choice conforms to such standard, the taxpayer's grouping "shall be controlling" and costs shall be allocated and apportioned to those groups. Treas. Reg. § 1.994-1(c)(6)(iv). Finally, costs "directly related" to those groups shall be allocated thereto, and costs directly related to specific products in non-export classes of income shall not be allocated to products generating export sales. *See* Treas. Reg. § 1.994-1(c)(6)(iii).

The Treasury regulation relating to the allocation or apportionment of R&D expenses (Treas. Reg. § 1.861-8(e)(3)) directly conflicts with the DISC legislative history and the DISC regulations. Under Treas. Reg. § 1.861-8 (e)(3), R&D expenses are allocated or apportioned to *all products* falling within broad two-digit categories, as enumerated in the SIC manual. Expenses are allocated to products in broad categories regardless of whether those expenses have any direct relationship to the products in the particular category. To the extent this regulation requires the allocation of R&D expenses that have no direct or definite factual relationship to specific products or product lines chosen by the taxpayer, the provision *is directly contrary* to the DISC statute, legislative history, and the DISC regulations. Consequently, as applied to such DISC determinations, Treas. Reg. § 1.861–8(e)(3) is unreasonable and invalid. *See St. Jude Medical*, 34 F.3d at 1396, 1402.

In this proceeding, Petitioners followed the applicable regulatory rules and chose to "group transactions" on the basis of specific product lines under recognized industry or trade usage, and not on the basis of the broad two-digit SIC

code category relating to "transportation equipment."[6] Despite the clear regulatory scheme, the Ninth Circuit found Petitioners were required to use the broad two-digit SIC code classification category, rather than the specific product lines selected by Petitioners pursuant to the right envisioned by Congress and granted under Treas. Reg. § 1.994-1(c)(7). Petitioners had an undeniable right to use the more specific product categories instead of the broad classifications imposed by the invalid Treasury regulation. *See St. Jude Medical,* 34 F.3d at 1396. *This right was intended by Congress for taxpayers across our country and was specifically granted by the Treasury regulations. See* H.R. Rep. No. 533, *supra*, at 74; Treas. Reg. § 1.994-1(c)(7)(i).

SUMMARY OF ARGUMENT

Congress enacted the R&D provisions of the Internal Revenue Code (26 U.S.C.) to encourage and promote innovative research and development efforts. Congress enacted the DISC and FSC provisions to stimulate activities resulting in the export of products from the United States. These incentives are of critical importance to companies throughout our nation.

The Ninth Circuit decision severely limits these incentives and undermines national policies encouraging R&D activities and granting export benefits. In a perverse way, the decision below increases the costs of companies conducting valuable R&D activities, thereby imposing financial penalties on those companies. The Ninth Circuit decision also dramatically diminishes the benefits of the export tax incentives promised by Congress, thereby directly impeding Congress's goal of increasing exports.

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[6] There is no disagreement that each of the product lines selected by Petitioners "constituted a separate product or product line under industry practice and trade usage." *See* Pet. App. A, at 2a; Pet. App. B, at 16a.

The decision by the court of appeals in this proceeding leads to negative practical consequences. The Ninth Circuit decision increases the costs of conducting innovative activity, severely limits the financial incentives enacted by Congress to operate manufacturing plants in the United States (leading to a potential loss of employment in our country), increases our trade deficit dilemma, and places United States companies at a global competitive disadvantage *vis-à-vis* companies located abroad. The decision by the court of appeals in this case should be reversed.

ARGUMENT

THE NINTH CIRCUIT DECISION UNDERMINES VITALLY IMPORTANT NATIONAL POLICIES

The decision below by the Ninth Circuit Court of Appeals is wrong as a matter of law. It is based solely on the application of an invalid Treasury regulation (Treas. Reg. § 1.861-8(e)(3)) to DISC determinations. *St. Jude Medical*, 34 F. 3d at 1396, 1402. The applicable statutory provisions, the relevant legislative history, and the controlling Treasury regulations, all support Petitioners' position and reversal of the decision below.

Equally important, the Ninth Circuit decision must be reversed because it is directly contrary to policies of vital national interest. Quite simply, the Ninth Circuit's analysis of the controlling authorities is strained and flawed because it is wholly inconsistent with the national interests reflected in those authorities, and directly conflicts with policies of immense importance to taxpayers throughout the United States.

The decision by the court of appeals below raises a fundamental question relating to the encouragement of R&D

activities and United States international trade policy. For many decades, the tax laws of our country have reflected national policies encouraging R&D efforts and stimulating export activities. The Ninth Circuit decision undermines those national policies by increasing the costs of conducting critical R&D activities and significantly diluting vital export incentives.

The relevant provisions of the Internal Revenue Code (26 U.S.C.) relating to R&D activities were enacted to encourage companies to engage in innovative research efforts. *See* Ways and Means Committee Rept., H.R. 8300, H.R. Rep. No. 1337, 83d Cong., 2d Sess. 28, 57 (1954). The DISC provisions were enacted to provide incentives for United States companies to increase their exports to other countries. *See* H.R. Rep. No. 533, *supra*, at 58. The decision below jeopardizes these essential national policies enacted to ensure United States companies are able to compete on a fair and balanced level in the world trade arena.

I. The Decision Below Frustrates Policies Designed to Encourage R&D Activities.

Research, development, and experimentation efforts constitute the innovative forces necessary for the development of new products and technologies and for maintaining and enhancing existing products. R&D efforts are critical activities that must precede the development and manufacture of new products, the application to production of new techniques and equipment, and the enhancement of existing technologies. These activities are essential to the growth and expansion of businesses in our country and the development of our economy. Congress has long recognized the important role of R&D efforts in the United States and has enacted laws designed to promote those activities.

A. National Policies Encouraging R&D Efforts.

National policies have existed for at least forty-eight years providing tax benefits to encourage taxpayers to carry on R&D activities. Prior to 1954, no specific treatment was authorized under the Internal Revenue Code for R&D expenses. Such expenditures were deductible to the extent they constituted ordinary and necessary expenses incurred in a trade or business. To the extent R&D expenditures were capital in nature, they were capitalized or amortized over the useful life of the item. Where the useful life could not be definitely determined, taxpayers had no ability to amortize the R&D expenses. *See* H.R. Rep. No. 1337, *supra*, at 28; S. Rep. No. 1622, 83d Cong., 2nd Sess. 33 (1954).

In 1954, Congress enacted a special provision in the Internal Revenue Code granting taxpayers an election to deduct currently R&D expenditures. *See* I.R.C. § 174(a). Under section 174, a taxpayer may elect to deduct R&D expenses paid or incurred during the taxable year (*see* I.R.C. § 174(a)), or treat such expenditures as deferred expenses that can be amortized over a period of not less than 60 months. *See* I.R.C. § 174(b)(1). This election was granted to "encourage taxpayers to carry on" R&D activities. *See* H.R. Rep. No. 1337, *supra*, at 28; S. Rep. No. 1622, *supra*, at 33; *Snow v. Commissioner*, 416 U.S. 500, 504 (1974).

In 1981, Congress expressed concern over our nation's decline in R&D activities. Congress noted that, relative to real gross national product, R&D expenditures had significantly declined in a recent 12-year period, and aggregate R&D spending in the United States had experienced a similar period of decline. *See* General Explanation of the Economic Recovery Tax Act of 1981, Joint Committee on Taxation, H.R. 4242, 97th Cong., 1st

Sess. 119 (1981). Congress concluded that "spending for these purposes had not been adequate." *Id.*

To reverse the decline in R&D spending, Congress decided that a substantial tax credit for incremental R&D expenditures was needed "to overcome the reluctance" by many companies to bear costs needed to "initiate or expand research programs." *Id.* at 120. Congress noted that many businesses had been "reluctant to allocate scarce investment funds for uncertain rewards." *Id.* In response, Congress enacted a new provision of the Internal Revenue Code (currently, I.R.C. § 41) allowing an income tax credit for certain qualified research expenditures incurred by a taxp er in carrying on a trade or business.[7] The purpose of the credit was to "encourage business firms to perform the research necessary to increase the innovative qualities and efficiency of the U.S. economy." Deficit Reduction Act of 1984 (Pub. L. No. 98-369), S. Prt. No. 169, Vol. 1, 98th Cong., 2d Sess. 904 (1984).

Congress believed that the new R&D tax credit would "stimulate a higher rate of capital formation and increased productivity" and would provide "incentives for greater private activity in research by operating businesses." *See* General Explanation of the Economic Recovery Tax Act of 1981, Joint Committee on Taxation, *supra*, at 120. The R&D credit was designed to assist companies in overcoming the reluctance "to bear the significant costs of staffing and supplies, and equipment expenses * * * which must be incurred to initiate or expand research programs in a trade or business." *Id.*

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[7] The R&D credit was originally enacted as I.R.C. § 44F, but was subsequently renumbered as I.R.C. § 30 (*see* Tax Reform Act of 1984, Pub. L. 98-369), and most recently as I.R.C. § 41 (*see* Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085).

At the time the R&D tax credit was enacted in 1981, an expiration date for the credit "was deemed desirable * * * to enable Congress to evaluate the experience with the credit and its operation, and to determine whether it should be extended * * *." Deficit Reduction Act of 1984 (Pub. L. No. 98-369), S. Prt. No. 169, *supra*, at 904. Reflecting the critical importance of the R&D tax credit, Congress subsequently extended the expiration date of the credit on 10 separate occasions during the period from 1986 through 1999.[8] Currently the R&D credit is extended through June 30, 2004.[9]

This history of continuous legislative action reflects strong national policies which have existed for almost fifty years, from the original enactment of the election to deduct R&D expenses in 1954 (I.R.C. § 174(a)) through the repeated extensions of the effective date of the R&D tax credit (I.R.C. § 41). These national policies are specifically intended to encourage United States taxpayers to engage in R&D activities designed to enhance existing products and create new products and technologies. *See* H.R. Rep. No. 1337, *supra,* at 28; S. Prt. No. 169, *supra*, at 904.

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[8] *See* The Tax Reform Act of 1986, Pub. L. No. 99-514, § 231(a); The Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342; The Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, § 7110; The Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388, § 11402(a); The Tax Extension Act of 1991, Pub. L. No. 102-227, 105 Stat. 1686, § 102(a); The Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13111; The Small Business Job Protection Act of 1986, Pub. L. No. 104-188, § 1204(a); The Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 601; The Tax and Trade Relief Extension Act of 1998, Pub. L. No. 105-277, § 1001; The Tax Relief Extension Act of 1999, Pub. L. No. 106-170, § 1001.

[9] The Tax Relief Extension Act of 1999, Pub. L. No. 106-170, § 1001.

B. <u>The Ninth Circuit Decision Undermines Congress's Efforts to Encourage R&D Activities</u>.

The R&D incentives in the Internal Revenue Code (26 U.S.C.) have encouraged the development of many existing and new innovative products and industries. Each of the *amici curiae* engages in significant R&D activities in its respective markets. Those activities are vitally important to the world class positions the *amici curiae* have attained in their industries. The Ninth Circuit decision below frustrates this key national policy encouraging R&D efforts because it increases the financial cost for companies engaging in R&D activities that yield products sold only in the domestic market, unsuccessful products, or products *otherwise unrelated to export income.*

Under the provisions of the DISC regime, the greater the DISC export profit, the larger the amount of the taxpayer's tax-deferred income and the resulting benefits intended by Congress. *See St. Jude Medical*, 34 F.3d at 1397. The Ninth Circuit decision significantly diminishes these benefits because every dollar of R&D expenditures *unrelated* to export receipts creates a financial disadvantage for companies to the extent those R&D expenses are allocated or apportioned to products sold for export under the DISC provisions (thereby reducing the company's tax-favored DISC export profit). Assuming a set of products in the same broad SIC code category, the rule adopted by the Ninth Circuit means that R&D expenses directly related to *unsuccessful products not brought to market* nevertheless must be allocated or apportioned to current export income under the DISC provisions. Further, R&D expenditures directly related to products sold *only in the domestic market* must also be allocated or apportioned to products sold for export.

Under the reasoning of the court below, every dollar of these R&D expenses *reduces* the tax-benefitted export profits and the tax incentives enacted by Congress. This rule applies even though the R&D expenses *are not factually related* to the taxpayer's export products. In essence, the court of appeals decision increases the cost of performing certain R&D efforts and imposes a financial cost on companies engaging in these R&D activities. Companies are actually penalized for engaging in R&D efforts *unrelated* to export activities and export income, such as R&D activities generating products sold in the domestic market or unsuccessful products that never reach the market. Such an aberrational result should not stand.

The practical effect of the decision below also creates serious inequities among different companies manufacturing products for export. For companies operating in industries that experience high failure rates in their R&D activities (that is, large numbers of unsuccessful products are produced), the Ninth Circuit decision unnecessarily penalizes these companies compared to other industries because the decision requires the allocation of expenses from those R&D efforts to successful products sold for export. Congress did not intend such an illogical result.

The Ninth Circuit decision imposes a significant financial cost on companies engaging in critical R&D activities, and runs directly counter to historically important policies reflected in legislation enacted by Congress for almost fifty years. The decision below undermines one of our nation's most fundamental policies: The encouragement of broad-based R&D activities to create innovative products and to enhance existing products and technologies. The detrimental impact of the decision below on this key national policy warrants reversal by this Court.

II. THE NINTH CIRCUIT DECISION IMPOSES FINANCIAL DISINCENTIVES ON EXPORT ACTIVITIES.

A. The Historical Importance of Export Incentives.

Congress has been vitally interested in promoting exports through special incentives in the Internal Revenue Code for more than sixty years. [10] One of the earliest export tax incentive regimes was enacted in 1942 for Western Hemisphere trade corporations ("WHTCs"). The WHTC regime was enacted to "alleviate * * * competitive inequality." S. Rep. No. 1631, 77th Cong., 2d Sess. 32 (1942). Until 1980, WHTCs enjoyed a fourteen percentage point reduction in the normal corporate tax rate related to exports and business activities conducted in the Western Hemisphere. I.R.C. §§ 921-922 (1954).

Commencing in the early 1970's, Congress enacted the first of three successive and interrelated regimes specifically designed to stimulate the manufacture of products for export from the United States. In 1971, Congress granted special tax benefits to DISCs to encourage the export of goods manufactured in the United States, and to equalize the taxation of United States companies with the European territorial system. *See* Pub. L. No. 92-178 (1971); S. Rep. No. 437, 92d Cong., 1st Sess. 90 (1971). Congress noted that the DISC regime was enacted to provide a "stimulative effect" for increased exports and to counterbalance other major trading nations that "encourage foreign trade by their domestic producers in one form or another." S. Rep. No. 437, *supra*, at 90.

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[10] *See* note 3, *supra*.

The DISC regime gave rise to complaints from other countries on the basis that it was an export subsidy in violation of the General Agreement on Tariffs and Trade. In 1984, Congress responded to these complaints by replacing the DISC rules with the closely related FSC provisions. *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, §§ 801-805, 98 Stat. 494.

Enactment of the FSC provisions did not deter attacks by other countries on our international trade policies, and in 2000 the World Trade Organization ("WTO") found that the FSC provisions were a prohibited export subsidy. In November 2000, Congress responded by repealing the FSC provisions and enacting a new provision referred to as the extraterritorial income exclusion ("ETI"). *See* Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 106th Cong., 2d Sess. (2000). The European Union filed a new complaint against the ETI provisions and in August 2001 a WTO panel held the new provisions also constituted a prohibited export subsidy.[11] Subsequently, in January 2002, an appellate body of the WTO modified and affirmed the panel's findings.[12] Because of the historic importance of these export tax regimes (DISC, FSC, and ETI), Congress is now considering various alternatives for resolving the WTO dispute while continuing to provide export incentives so that United States businesses can compete on a fair and level playing field with companies based abroad.[13]

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[11] United States--Tax Treatment for "Foreign Sales Corporations" -- Recourse to Article 21.5 of the DSU by the European Communities, WT/DS108/RW, Report of the Panel, August 20, 2001.

[12] *Id.*, as modified by the Appellate Body, January 14, 2002, adopted January 29, 2002.

[13] *See* Hearings Before the House Committee on Ways and Means on the WTO's Extraterritorial Income Decision (February 27, 2002). It is

B. Policy Objectives of Encouraging Export Activities.

This long history of disputes relating to United States exports, international trade policies, and successive enactments by Congress of export incentives evidence vital national policies. It is in our national interest to encourage the export of products from the United States. Export activities create domestic jobs, facilitate capital investment, encourage construction of plants in our country, improve our balance of payments position, favorably impact interest rates, and support the value of the United States dollar in markets throughout world. Congress has recognized the importance of these national objectives and has sought to provide export incentives to United States businesses continually over the last sixty years.

Congress specifically enacted the DISC statute in 1971 to provide tax incentives to increase exports of products produced in the United States and in response to incentives provided by other major trading nations fostering foreign trade and encouraging exports by their domestic producers. *See* S. Rep. No. 437, 92d Cong., 1st Sess. 90 (1971); *Caterpillar Tractor Co. v. U.S.*, 589 F.2d 1040, 1044 (Ct. Cl. 1978). The FSC and ETI regimes continue this congressional policy of providing incentives to stimulate export activities.

In enacting the DISC provisions, Congress provided taxpayers incentives to "maximize DISC profit." *See St. Jude Medical*, 34 F.3d at 1397. In computing the maximum

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anticipated that the regulations interpreting the ETI provisions, as well as any subsequent legislation, will also present the issue in this proceeding. Consequently, this issue has continuing importance and relevance from the original DISC legislation, through the FSC and ETI provisions, and the anticipated future legislation in this area.

DISC benefit, Congress intended that "directly related" expenses should be allocated to export income. H.R. Rep. No. 533, *supra,* at 74. Congress further intended to grant taxpayers the right to choose groupings by specific product or product lines, and to allocate expenses directly related to those products or product lines. *See* H.R. Rep. No. 533, *supra*, at 74. The Treasury regulations reflect these basic principles (Treas. Reg. §§ 1.994-1(c)(6)(iii), 1.994-1(c)(7)(i)), and this right to group transactions has been codified in subsequent export legislation.[14]

It is in our country's national interest to encourage the development of domestic production facilities and thereby increase employment in the United States. Our national interests are served by reducing our trade deficit, strengthening the value of our currency abroad, and lowering our interest rates. Export incentives are critical factors in achieving these goals. Congress has acknowledged and supported these important national interests through the enactment of legislation designed to stimulate export activities. The Ninth Circuit decision ignores these critical objectives and our national interests.

C. The Decision Below Frustrates Congressionally-Mandated Export Incentives.

Contrary to the legislative intent and regulatory scheme underlying the DISC regime, the Ninth Circuit decision requires taxpayers to allocate R&D expenses to all products in broad SIC code product categories (rather than the specific product groupings selected pursuant to the right granted by Congress and reflected in the Treasury regulations). The approach of the court below requires the allocation of R&D expenses which are specific to particular products to *entirely*

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[14] I.R.C. § 927(d)(2)(B) (1984) (FSC regime), I.R.C. § 943(b)(1)(B) (2000) (ETI regime).

unrelated products sold for export, thereby diluting the incentives enacted by Congress. Quite simply, Congress never intended to significantly reduce the benefits under the export legislation by requiring *unrelated* R&D expenses to be allocated to sales of export products.

Indeed, in an effort to minimize the reduction of the benefits from these incentives, Congress provided exporters the right to "group transactions" on a product or product line basis. Subsequent legislation and the Treasury regulations have reinforced this intent by codifying the right to group transactions on a product or product line basis. *See* I.R.C. § 927(d)(2)(B) (1984) (FSC regime); I.R.C. § 943(b)(1)(B) (2000) (ETI regime); Treas. Reg. § 1.994-1(c)(7)(i). As a result, the court of appeals decision below is contrary to the congressional intent behind the DISC provisions and frustrates key national policies designed to encourage and increase exports.

The court of appeals decision below also leads to negative practical consequences. The DISC regime was enacted to encourage production of export products in the United States, rather than supplying products to customers from overseas locations. *See* H.R. Rep. No. 533, *supra*, at 58. The Ninth Circuit decision reduces the financial advantages of producing products in the United States. Movement of production capacity overseas leads to plant closures and the loss of jobs in United States. Reduction in exports exacerbates our foreign trade deficit, and negatively impacts interest rates in our country and the value of the United States dollar abroad. *In an economic environment where our nation is struggling to emerge from its first recession in a decade, these are critical practical considerations that emerge from the decision below and justify reversal by this Court.*

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The essence of this proceeding is a conflict of overwhelming importance to companies across our nation engaged in R&D efforts and the production of products for export. This proceeding will determine whether vital national policies encouraging R&D activities and stimulating exports from the United States will be frustrated by the Ninth Circuit decision. This Court should not allow such an irrational result.

CONCLUSION

The decision below by the United States Court of Appeals for the Ninth Circuit should be reversed.

Respectfully submitted,

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